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No. 98-1065

IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

INDIANAPOLIS POWER & LIGHT COMPANY,

Petitioner,

vs.

PENNSYLVANIA PUBLIC UTILITY COMMISSION
and PECO ENERGY COMPANY,

Respondents

ON PETITION FOR WRIT OF CERTIORARI
TO THE COMMONWEALTH COURT
OF PENNSYLVANIA

BRIEF IN OPPOSITION FOR RESPONDENT PECO ENERGY COMPANY

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QUESTION PRESENTED

Whether Pennsylvania's Electricity Generation Customer Choice and Competition Act, which opens up the retail electric market to competition and allows incumbent utilities to recover costs previously incurred by them to satisfy their statutory obligation to serve, violates the "dormant" Commerce Clause.

STATEMENT PURSUANT TO RULE 29.6

Respondent PECO Energy Company has no parent companies or subsidiary companies that are nonwholly owned.

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STATEMENT OF THE CASE

Invoking the "dormant" Commerce Clause, Petitioner challenges the constitutionality of an order of the Pennsylvania Public Utility Commission ("PPUC") allowing PECO Energy Company ("PECO") to recover from its customers certain costs that it previously incurred in meeting its state-imposed obligation to provide regulated electric service in southeastern Pennsylvania. The recovery of such costs is an integral part of the Electricity Generation Customer Choice and Competition Act, 66 Pa. Cons. Stat. § 2801 (1996) *et seq.* (the "Competition Act"), a comprehensive statutory scheme implementing competition for electric generation at the retail level in Pennsylvania.

A. The State Statutory Background Of The Challenged Order

Under the regulatory regime in place in Pennsylvania prior to enactment of the Competition Act, electric utilities were obligated to provide "bundled" services to all customers in their certificated territories.[1] As part of this statutory obligation, electric utilities were held to high standards of reliability, requiring them to build and maintain sufficient generating capacity to ensure continuous service to current customers and to meet projected future growth in demand. In addition, utilities historically have been subject to stringent rate regulation, whereby they were provided an opportunity to recover their operating costs, to earn a reasonable return on their investment and to recoup that investment over the lives of the underlying facilities.[2] This matrix of obligations and rights was summarized by the PPUC as follows:

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1. "Bundled," in this context, refers to the three principal functions of electric utilities — the generation, transmission and distribution of electricity.

2. The development of electric utility regulation closely parallels that of the natural gas industry. This parallel is discussed at length by Justice Souter in *General Motors Corp. v. Tracy*, 117 S. Ct. 811 (1997).

> Electric utilities have invested heavily in their generation assets based on the existing system of rate base/rate of return regulation. That is to say, a utility receives a certificated service territory in which it is the supplier of power. In return it commits to build its system as necessary to serve the current and future needs of all customers in the service area. The utility is then allowed to recover the cost of the prudent investment it makes to provide such service, plus the opportunity to earn a regulated return on investment.

Report And Recommendation On the Investigation Into Retail Electric Competition, Docket No. I-940032 (Pa. P.U.C., July 3, 1996) (p. 20) ("*PUC Report On Retail Electric Competition*"), Respondents' Joint Appendix ("RJ App.") 14a. *See also Re Lukens Steel Co.*, 58 Pa. P.U.C. 256, 261 (1984), *aff'd sub nom. Lukens Steel Co. v. Pennsylvania Pub. Util. Comm'n*, 92 Pa. Commw. 530, 499 A.2d 1134 (1985) ("[W]hen a public utility is certificated to serve a particular service area, it undertakes an obligation or duty to serve this certificated area, and from this duty flows a right to serve customers desiring service within the certificated service area.").[3]

The enactment of the Competition Act in the Fall of 1996 effected a fundamental restructuring of the electric industry in Pennsylvania. The Competition Act requires that the generation

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3. Additionally, Pennsylvania's electric utilities have been and remain the vehicle for implementing various social and public benefit programs that do not directly relate to the generation, transmission or distribution of electricity, such as financial assistance to low-income customers, customer service protection, energy efficiency and renewable energy, research and development, and public information and education. *See PUC Report On Retail Electric Competition*. RJ App. 1a-20a.

function of the electric supply industry be opened to competition. *See* 66 Pa. Cons. Stat. § 2802(13) and (14). Following a brief phase-in period, all consumers in Pennsylvania will be permitted to choose their electricity suppliers, which may include their incumbent utility, other in-state utilities, out-of-state utilities and other non-utility generators and marketers. At the same time, other aspects of Pennsylvania's electric industry will remain heavily regulated. For example, transmission and distribution services are not being opened up to competition; these functions will remain the duties of the local utility. *Id.* § 2802(16). Moreover, the local utility will remain as the "provider of last resort," acting as a default provider for customers who do not or cannot obtain an alternative supply or whose alternative supplier fails to deliver the contracted-for generation. *Id.* § 2807(e). Finally, the rates that the local utility may charge for its services are capped for prescribed periods at levels in effect on January 1, 1997. *Id.* § 2804(4).

Prior to the Competition Act, Pennsylvania's utilities prudently incurred substantial generation costs to satisfy their statutory duty to serve. Not all of these costs, which otherwise would have been recovered through regulated rates, are likely to be recoverable through market-determined prices. Recognizing that these "stranded" costs were a result of the previous regulatory structure and that the ongoing reliability of local utilities is crucial (*Id.* § 2802(12)), the Competition Act provides as follows:

> (15) In establishing the standards for the transition to and creation of a competitive electric market, heretofore, public utilities generally have had an obligation to serve customers within their defined service territories; consistent with that obligation, have undertaken long-term investments in

> generation, transmission and distribution facilities in order to meet the needs of their customers; and have entered into long-term power supply agreements as required by Federal law. In many instances, these investments and agreements have created costs which may not be recoverable in a competitive market. The commission is empowered under this chapter to determine the level of transition or stranded costs for each electric utility and to provide a mechanism, the competitive transition charge, for recovery of an appropriate amount of such costs in accordance with the standards established in this chapter.

66 Pa. Cons. Stat. § 2802(15).

The Competition Act thus provides that a utility, subject to PPUC approval, may recover its stranded costs through a "competitive transition charge" to be paid by "every customer accessing the transmission or distribution network . . . to the electric distribution company in whose certificated territory that customer is located." *Id.* § 2808(a). A utility may also invoke provisions of the Competition Act that allow it to "securitize" all or a portion of its stranded costs, subject to the PPUC's determination that doing so would be "just and reasonable" and "in the public interest." *Id.* § 2812(a)(2)(iii).[4] If a utility "securitizes," it recovers its stranded costs, less any savings achieved through the securitization process, through "Intangible Transition Charges" such as those at issue in this case.

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4. Through securitization, a utility converts its entitlement to recover stranded costs into a current, fully vested property right that may be sold or pledged as security for the issuance of "transition bonds." Because the interest rate payable on the transition bonds will likely be lower than the cost of the utility's existing capitalization, the bond proceeds must be used principally to reduce stranded costs and related capitalization. 66 Pa. Cons. Stat. § 2812(b)(2).

The Competition Act applies equally to all electric companies providing public utility service in Pennsylvania, regardless of their state of incorporation or principal place of business.[5] However, only those utilities which demonstrate that their prior investments will result in the stranding of costs are entitled to impose "competitive transition charges" or "intangible transition charges." Non-utility generators and marketers, whether resident in Pennsylvania or elsewhere, are not subject to the stranded cost provisions of the Competition Act because they have not borne public service obligations.

B. The Proceeding Before The Pennsylvania Public Utility Commission

In January 1997, PECO sought an order from the PPUC authorizing it to securitize $3.8 billion of its $7.0 billion of stranded costs. More than thirty parties intervened, representing a broad array of consumer interests, environmental groups, and prospective in-state and out-of-state competitors. An evidentiary record of several thousand pages was produced. The factual and expert testimony covered a wide range of issues, including such matters as the amount of stranded costs that PECO would actually incur, whether allowing recovery of stranded costs was likely to induce utilities to engage in anticompetitive behavior, and the details of the procedures that PECO would use to securitize its stranded cost revenue stream. Petitioner Indianapolis Power & Light Company ("Petitioner" or "IPL") participated fully in the proceeding before the PPUC and, as in this Court, argued that allowing stranded cost recovery would violate the Commerce Clause.

Following extensive evidentiary hearings and briefing, the PPUC, in May 1997, approved, in part, PECO's securitization

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5. In fact, more than half of Pennsylvania's electric utilities are part of multi-state utility systems whose parent company is either incorporated or headquartered in another state.

request. Pet. App. 39a-145a. The PPUC concluded that it was just and reasonable to allow PECO to recover $1.098 billion of the $3.8 billion in stranded costs that it sought to securitize. The PPUC further found that it was in the public interest to allow PECO to securitize those costs and to recover that securitized revenue stream from customers. In so ruling, the PPUC considered and rejected the argument that PECO's recovery of stranded costs would discriminate against other suppliers and would impose an impermissible burden on interstate commerce, concluding that "[t]here is simply no factual basis upon which to make such a determination." Pet. App. 63a.[6]

C. The Proceeding In The Commonwealth Court Of Pennsylvania

Petitioner appealed the PPUC's Order to the Commonwealth Court of Pennsylvania.[7] Petitioner argued that the Competition Act is unconstitutional under the dormant Commerce Clause insofar as it allows PECO to recover stranded costs. IPL further contended that, as a "reasonable and less discriminatory" means of achieving its objectives, Pennsylvania should have required that incumbent utilities divest the assets they use to generate electricity as a precondition to recovering stranded costs.[8] In other words, IPL maintained that any entity

6. The PPUC dismissed the Commerce Clause arguments in the process of responding to arguments advanced by a group of intervenors identified as the "Environmentalists." Pet. App. 43a.

7. In Pennsylvania, the Commonwealth Court has jurisdiction over challenges to final determinations of state agencies. 42 Pa. Cons. Stat. § 763 (1978).

8. Under the Competition Act, the PPUC may permit, but may not require, the divestiture of generation facilities. 66 Pa. Cons. Stat. § 2804(5).

that collected stranded generation costs was constitutionally compelled to refrain from competing in the developing interstate generation market.

By Opinion and Order issued May 7, 1998, the Commonwealth Court rejected Petitioner's appeal on several different grounds. First, it concluded that the Competition Act did not implicate the underlying concerns of the dormant Commerce Clause, both because the Act's overall purpose and effect was to create and foster an interstate electric generation market and because the states have been apportioned jurisdiction to regulate retail electric rates. Pet. App. 13a-22a.[9] The Commonwealth Court also pointed out that the Federal Energy Regulatory Commission ("FERC") had recognized the importance of stranded cost recovery, thereby refuting any assertion that the sole purpose of such recovery is to promote domestic industry and interfere with interstate competition. Pet. App. 25a.

Even though it found that the Competition Act did not implicate the Commerce Clause, the Commonwealth Court went on to apply the two-tiered test developed by this Court in *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970) ("*Pike*"). Because the overall purpose and effect of the Competition Act is to promote and not interfere with interstate commerce, the Commonwealth Court reasoned that strict scrutiny was inappropriate and that the Competition Act instead should be evaluated in light of the more relaxed balancing standard articulated by this Court in *Pike*. Under that standard, a state statute will be sustained "unless the 'burden imposed on interstate commerce is clearly excessive in relation to the putative local benefits.'" Pet. App. 28a, quoting *Pike*, 397 U.S. at 142.

9. In this regard, the Commonwealth Court noted that "[t]he transition charges are nothing more than a different manifestation of the previously regulated rates." Pet. App. 16a.

Applying this test to the facts, the Commonwealth Court had no difficulty in upholding the Competition Act. Indeed, in a unanimous decision, the Commonwealth Court catalogued numerous "local interests," each of which alone would suffice to justify whatever incidental effect, if any, stranded cost recovery might have on interstate commerce. Such "local interests" included: (1) regulating retail sales by electric utilities (Pet. App. 30a); (2) preserving the viability of local transmission and distribution networks (Pet. App. 31a); (3) ensuring reliable generation service to all consumers (i.e., the incumbent utilities' "provider of last resort" responsibilities) (Pet. App. 31a); (4) providing assistance to low-income customers (Pet. App. 31a-32a); (5) assuring the safe decommissioning of nuclear power plants located in Pennsylvania (Pet. App. 32a-33a); and (6) maintaining fundamental fairness to investors and employees (Pet. App. 33a).[10]

Finally the Commonwealth Court held, as a matter of Pennsylvania law, that the stranded cost recovery provisions of the Competition Act were not severable from the remainder of the Act. Pet. App. 33a-36a. This is significant because, as the Commonwealth Court further observed, acceptance of IPL's Commerce Clause argument "would mutilate the Competition Act" and "would lead us to eradicate the very thing [competition] that gives IPL standing before this Court." Pet. App. 34a-35a.

On June 4, 1998, Petitioner sought leave to appeal the Commonwealth Court's decision to the Supreme Court of Pennsylvania. That Court denied review by *per curiam* order dated September 29, 1998. Pet. App. 145a.

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10. The Commonwealth Court also rejected Petitioner's divestiture alternative, concluding that divestiture would "jeopardize Pennsylvania's electric utility service." Pet. App. 30a.

SUMMARY OF ARGUMENT

The writ should be denied because it is not worthy of this Court's review. No conflict of authority in the lower courts has been alleged. Moreover, as the Petition plainly reveals, IPL's real complaint is not with the Commonwealth Court's articulation of the law, but instead with its failure to overturn the PPUC's factual findings.

Petitioner's reliance on this Court's decision in *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) ("*West Lynn Creamery*") is misplaced. There is no new tax here, no subsidization designed to provide domestic industry a competitive advantage, and the Competition Act opens up Pennsylvania's borders to interstate competition in generation for the first time. As part of this effort to introduce competition, the Act properly affords electric utilities an opportunity to recover costs that they previously incurred in satisfying their statutorily mandated obligation to serve, costs they would have recovered through the regulatory process if Pennsylvania had never introduced retail competition.[11]

Nor, for that matter, is such reimbursement extended to all electric suppliers in Pennsylvania and denied all others. In contrast to *West Lynn Creamery*, the Competition Act does not draw a line at the state border. Rather, the right to claim stranded costs flows to those entities that made a commitment in the past to public utility service and that continue to operate subject to various state-imposed public service obligations. As such, utilities doing business in Pennsylvania, whether resident or not, qualify for stranded cost recovery; other suppliers that never

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11. As the Commonwealth Court observed: "[S]tranded-cost recoveries are not a fortuitous gift from the Commonwealth to PECO as IPL argues; they represent identifiable and limited reimbursements to which PECO is entitled." Pet. App. 13a.

enjoyed public utility status, whether in-state or out-of-state, do not.

IPL's assertion of "facial discrimination" fails for the additional reason that Pennsylvania's former monopoly providers are not "substantially similar entities" to those in-state and out-of-state suppliers that wish to compete against them. *General Motors Corp. v. Tracy*, 117 S. Ct. 811 (1997) ("*Tracy*"). Pennsylvania's incumbent utilities must continue to serve as "provider of last resort" for electricity in Pennsylvania; they retain the statutory duty to furnish transmission and distribution service; and they remain obligated to fund and to administer numerous social and public benefit programs. Alternative generation suppliers like IPL, on the other hand, can freely come and go based solely on their perception of the profitability of the Pennsylvania market.

Even if there were some basis for its facial challenge to the Competition Act, Petitioner's extraordinary "less restrictive alternative" — the compelled divestiture by Pennsylvania's electric utilities of their generating facilities — was expressly rejected by the Pennsylvania Legislature. Furthermore, there is no evidence in this proceeding that the forced sale of such assets would promote competition. Indeed, it is more likely that the elimination of a whole class of potential competitors — Pennsylvania's electric utilities — from the competitive generation market would have precisely the opposite effect.

Finally, this is a particularly poor vehicle for consideration of constitutional questions. There is no split of authority in the lower courts. No compelling reason is offered for this Court to intervene into a newly developing area of state economic policy. Moreover, IPL has failed to show "imminent harm" or a demonstrated intention to compete for retail customers in Pennsylvania and thus lacks standing. *Lujan v. Defenders of*

Wildlife, 504 U.S. 555, 560-61 (1992) (internal quotation omitted). The Commonwealth Court's conclusion that the stranded cost recovery provisions are not severable from the remainder of the Competition Act further undermines IPL's position. For all these reasons, the requested writ of certiorari should be denied.

REASONS FOR DENYING THE WRIT

I.

THE PETITIONER'S RELIANCE ON *WEST LYNN CREAMERY* IS MISPLACED.

This Court addressed Commerce Clause issues in the context of utility deregulation less than two years ago in *Tracy*. IPL does not suggest that any split has developed in Commerce Clause jurisprudence since that time, either among the circuits or the states. Rather, the Petition accepts (Pet. 14) that *Tracy* is "important Commerce Clause precedent[]" on utility deregulation, but argues that its import was misconstrued by the Commonwealth Court. As such, the Petitioner does not seek this Court's guidance on an unresolved or contentious issue of law, but instead claims that well-developed legal precedent was misapplied to the facts of this case.

The Commonwealth Court adhered to this Court's two-tiered analysis of Commerce Clause challenges. Pet. App. 28a. Under this approach, it must first be determined whether a statute "facially discriminates" against interstate commerce. If so, a statute will be struck down unless the state can demonstrate that the statute serves a legitimate local purpose and that such a purpose could not be served by some other reasonably available non-discriminatory means. *See C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 392-93 (1994); *see also*

Maine v. Taylor, 477 U.S. 131, 138 (1986); *Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979).[12] If a statute is not facially discriminatory, a more deferential "balancing" test applies whereby a state statute will be nullified only if it imposes a burden on interstate commerce that is "clearly excessive in relation to the putative local benefits." *See Pike*, 397 U.S. 137, 142 (1970); *see also Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 471 (1981).

Petitioner, in its challenge to the Competition Act, relies almost exclusively on *West Lynn Creamery*. However, none of the factors that troubled this Court in that case are present here. To the contrary, the purpose and effect of the Competition Act is to promote competition, not impede it; no attempt has been made to subsidize domestic industry; and potential competitors are not discriminated against on the basis of state of incorporation or residence. As a consequence, the Commonwealth Court properly concluded that "the Competition Act as a whole does not discriminate in purpose or effect," Pet. App. 29a, and that this case is "factually dissimilar" from *West Lynn Creamery*. Pet. App. 14a.

In stark contrast to *West Lynn Creamery*, the recovery of stranded costs does not bestow a subsidy of any kind or advance

12. Statutes are generally found to be facially discriminatory under the Commerce Clause only in limited circumstances — where goods or services supplied by out-of-state entities are totally excluded from an in-state market, where such goods or services are subject to a greater tax burden than those of in-state entities, or where material otherwise may not be shipped out of or into the state. *See, e.g., Fort Gratiot Sanitary Landfill, Inc. v. Michigan Dept. of Natural Resources*, 504 U.S. 353 (1992) (statute banning disposal of out-of-state waste in Michigan); *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334 (1992) (statute imposing extra fee on out-of-state waste disposed of in Alabama); *Taylor*, 477 U.S. 131 (statute prohibiting import of fish into state); *Hughes*, 441 U.S. 322 (statute prohibiting export of fish from state).

incumbent utilities' competitive position. Rather, it constitutes restitution for costs prudently incurred under a prior regulatory regime. The Commonwealth Court recognized this crucial distinction when it bluntly stated: "IPL has not convinced us that the Competition Act or the stranded-cost provisions afford any [competitive] advantage." Pet. App. 12a. Moreover, there is ample evidentiary support for PECO's contention that the combination of low entry barriers and low marginal pricing in the electric industry would negate any effort to use stranded cost proceeds for anticompetitive purposes.[13]

In addition, the Competition Act does not discriminate, facially or otherwise, between in-state and out-of-state suppliers. Instead, it draws a distinction between utilities regulated by the PPUC (i.e., firms that were obligated to construct needed facilities to serve Pennsylvania customers and that remain obligated to serve them as providers of last resort) and everyone else. Thus, when it comes to the recovery of stranded costs or the imposition of competitive transition charges, IPL and a Pennsylvania non-utility generator are treated precisely the same.

Finally, as this Court made abundantly clear in *Tracy*, "any notion of discrimination assumes a comparison of *substantially similar entities*." 117 S. Ct. 811, 824 (emphasis added).[14] Yet, in terms of their competitive posture, public utilities and other

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13. PECO presented evidence on this issue from Dr. William Hieronymus, a Ph.D. economist with specific expertise in this area. Dr. Hieronymus' testimony on this issue is reproduced in full in Respondents' Joint Appendix. RJ App. 25a-29a.

14. *Tracy* involved taxes imposed on sales of natural gas in Ohio from which local natural gas distribution companies were exempt. Proceeding cautiously against the complex historical and economic background of state regulation of retail sales of natural gas, this Court rejected a Commerce Clause challenge.

prospective suppliers could not be more dissimilar. Indeed, the Competition Act imposes substantial ongoing obligations on PECO and other incumbent utilities that are not shared by IPL or other non-utility suppliers:

- To stand as the provider of last resort for all customers in its service territory for as long as it is collecting stranded investment from its customers.[15]

- To provide universal service to low-income customers.

- To decommission nuclear plants — a task which even Petitioner recognizes as a valid state interest.

- To provide distribution and transmission services — again, Petitioner recognizes the protection of this function as a valid state interest.

And, PECO must do all of these things while laboring under statutorily imposed rate caps to which Petitioner and other competitors are not subject. 66 Pa. Cons. Stat. § 2804(4).

IPL seems to acknowledge that some level of stranded cost recovery would be lawful. In particular, Petitioner accepts that nuclear decommissioning and protecting the financial integrity of distribution and transmission services are valid local interests, but challenges the amount allocated for those purposes

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15. Subject to certain conditions being met, the PPUC may designate an entity other than the incumbent utility to serve as provider of last resort. 66 Pa. Cons. Stat. § 2807(e). To date, however, the PPUC has taken no action to relieve incumbent utilities of that responsibility.

by the PPUC. Pet. 26-27. In addition, IPL's chief financial officer testified that "IPL does not oppose stranded cost recovery per se." RJ App. 30a. Since Petitioner's assessment of the Competition Act apparently turns on the *amount* of stranded cost recovery provided, there is simply no basis for concluding that the Act violates constitutional norms as a matter of law.

In sum, this case fundamentally differs from *West Lynn Creamery* and every other decision which has found that a state law is impermissibly discriminatory or otherwise furthers improper protectionist goals. This is because the purpose and effect of the Competition Act is to promote interstate commerce by opening up Pennsylvania to competition that did not previously exist.

After concluding that the Competition Act did not facially violate the Commerce Clause, the Commonwealth Court conducted the balancing test called for in *Pike*, weighing the alleged adverse effect on interstate commerce against Pennsylvania's local interests. Based on the record before it, the Commonwealth Court found that the balance tipped decidedly in favor of sustaining the Competition Act and the Petitioner does not seriously challenge that conclusion. In any event, the particulars of such fact-specific balancing do not warrant this Court's review. *See Tracy*, 117 S. Ct. at 829. ("[T]he Court is institutionally unsuited to gather the facts upon which economic predictions can be made. . . .")

The Petitioner, in essence, seeks to have this Court judicially mandate that Pennsylvania convey the economic benefits of its new competitive regime to new market entrants while, at the same time, ignoring the economic harm caused to incumbent utilities that incurred substantial and, to date, unrecovered costs in satisfying their historic obligation to serve.

But nothing in the Commerce Clause imposes such an inequitable straightjacket on state legislatures. Rather, states maintain their flexibility under a federalist system *both* to provide the benefits of competition to consumers and to recompense utilities for prior investments made when they were regulated as natural monopolies.[16] IPL has presented no basis for this Court to forestall the states' experimentation on this issue by preventing, in the name of the Commerce Clause, any means of striking a reasonable balance between these competing economic interests.

II.

THE PETITIONER'S PROPOSED DIVESTITURE OPTION IS NOT A REASONABLY AVAILABLE, NON-DISCRIMINATORY ALTERNATIVE MEANS OF PROMOTING COMPETITION.

Petitioner has argued that the Competition Act can only be sustained if the recovery of stranded costs is conditioned on the utility's departure from the newly created competitive generation market. This option, however, cannot possibly be considered a reasonably available, non-discriminatory means of accomplishing Pennsylvania's policy goals, *see C & A Carbone*, 511 U.S. at 392, since it would effectively eliminate from the field all of Pennsylvania's incumbent electric utilities. Such exclusion would not promote competition — it would likely impede it.

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16. Indeed, a contrary ruling might well have the perverse effect of closing state borders to competition by forcing states to choose between the impermissible extremes of severely harming, if not bankrupting, those companies that have previously borne the burden of providing electricity to all customers or continuing forever a monopolistic, in-state regime.

Apart from the irony of arguing that the elimination of an interstate competitor is a remedy called for by the dormant Commerce Clause, Petitioner's insistence on divestiture is premised on assumptions unsupported by evidence proffered below. IPL did not attempt before the PPUC or the Commonwealth Court to establish that divestiture would actually be a less drastic means (in terms of its effect on interstate commerce) of achieving the Commonwealth's legitimate objectives than the means chosen in the Competition Act. Nor did Petitioner introduce evidence that divestiture would actually accomplish those objectives.[17]

If anything, the Petitioner's proposed divestiture alternative underscores the correctness of the Commonwealth Court's decision. Forcing those generators who recover stranded costs to divest themselves of their generating capacity would be completely inconsistent with the recognized purposes of the dormant Commerce Clause. Petitioner's thesis is that the best means to eradicate the effects of alleged "discrimination" between in-state competitors and out-of-state competitors is to eliminate an entire class of in-state competitors. This argument, however, completely disregards the underlying goal of vigorous competition that the Commerce Clause seeks to protect.

III.

THIS CASE IS A PARTICULARLY POOR VEHICLE FOR CONSIDERATION OF CONSTITUTIONAL QUESTIONS.

A. There Is No Conflict Of Authority In The Lower Courts

This Court's jurisprudence under the dormant Commerce Clause establishes clear lines of legal analysis, albeit analysis

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17. In fact, the record developed by IPL on the divestiture alternative comprises less than one page and is reproduced virtually in full in the Petition. Pet. 25.

that leads to different results on different fact patterns. At no point does the decision of the Commonwealth Court deviate from these clear lines or create a conflict among the lower courts — state or federal — over an issue of law that might justify this Court's attention. In its treatment of both federal law and state law, the Commonwealth Court's opinion applies established precedent, based upon the facts as found in the record. Petitioner's arguments amount to no more than a claim that the Commonwealth Court failed to see the facts as IPL sees them. This contention does not justify further review.

B. The Petition Seeks This Court's Intervention Into A Newly Developing Area Of State Economic Policy

The new interstate market that the Competition Act seeks to promote is as yet undeveloped, and its future will be shaped by economic forces not yet fully understood and, undoubtedly, technological innovations not yet foreseen. Different states will likely support this experiment in different ways. Some states will perhaps not support this incipient market at any level, but rather will continue to exercise the jurisdiction apportioned to them under the Federal Power Act to allow and regulate local monopolies over retail electric sales and access to local distribution facilities. *See* 16 U.S.C. § 824(b) (1992) (limiting federal agency authority to regulating "the sale of electric energy at wholesale in interstate commerce" and specifically recognizing state jurisdiction over "facilities used in local distribution or only for the transmission of electric energy in intrastate commerce").[18] This is not an appropriate time for

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18. This Court has described this language in the following terms:

> [W]hatever reason or combination of reasons led Congress to put the provision in the Act, we think it meant what it said by the words "but shall not have jurisdiction, except

(Cont'd)

intervention by this Court. "To stay experimentation in things social and economic is a grave responsibility. Denial of the right to experiment may be fraught with serious consequences to the Nation." *Reeves, Inc. v. Stake*, 447 U.S. 429, 441 (1980) quoting *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J. dissenting).

C. The Petitioner Has Not Established Standing

This Court is subject to the case or controversy limits of Article III of the Constitution. To satisfy that requirement, the party invoking federal judicial power must demonstrate that he has suffered "injury in fact," that the injury is "fairly traceable" to the actions of the defendant, and that the "injury will likely be redressed by a favorable decision." *Bennett v. Spear*, 117 S. Ct. 1154, 1161 (1997) (internal quotation omitted). The Petition does not allege, much less demonstrate, "injury in fact" to IPL.[19]

(Cont'd)

> as specifically provided in this Part or the Part next following . . . over facilities used in local distribution." Congress by these terms plainly was trying to reconcile the claims of federal and of local authorities *and to apportion federal and state jurisdiction over the industry.*

Connecticut Light & Power Co. v. Federal Power Comm'n, 324 U.S. 515, 530-31 (1945) (emphasis added).

19. Petitioner's standing in the earlier state proceedings does not imply standing in this Court.

> We have recognized often that the constraints of Article III do not apply to state courts, and accordingly the state courts are not bound by the limitations of a case or controversy . . . [even] when they are called upon to interpret the Constitution. . . .

(Cont'd)

IPL notes, in its Petition, that it "intervened before the [PPUC] and presented evidence that, *inter alia*, requiring consumers to pay these stranded generation cost charges to PECO would disadvantage competing producers in the market for electric generation." (Pet. 4, citing Pet. App. 259a-260a). The Petition does not assert, however, that IPL is such a competitor.[20] Rather, IPL's standing theory is simply that it might compete with PECO in the future and that it therefore has an interest in ensuring that PECO does not receive a financial benefit today that it might later use to subsidize its competitive efforts. By this logic, Petitioner would have "standing" to challenge every rate order sought by every generating utility in the country.

Article III requires more than a theoretical possibility of injury in the future. When a federal plaintiff grounds its claim to standing on anticipated future injury, it must show "that the injury complained of . . . if not actual, [is] at least *imminent*. . . ." *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 564 n.2 (1992) (emphasis in original). IPL has not demonstrated an "imminent" threat that it will compete with PECO for retail

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(Cont'd)

ASARCO Inc. v. Kadish, 490 U.S. 605, 617 (1989). Thus, notwithstanding a petitioner's standing in state court, this Court will not "accept as the basis for review," a matter which does not constitute a concrete case or controversy under Article III. *See Doremus v. Board of Educ.*, 342 U.S. 429, 434 (1952).

20. IPL has not filed an application with the PPUC to do business in Pennsylvania. At the same time, more than 75 entities have been licensed by the PPUC to operate as electric generation suppliers and many of those licensees began providing service to hundreds of thousands of customers when generation competition in Pennsylvania commenced on January 1, 1999. It is therefore no answer for IPL to say that it is unwilling to commit resources to competing in Pennsylvania as long as the "unfair" stranded investment rules are in place.

sales in Pennsylvania or that PECO would use stranded cost recovery "to sell power well below PECO's cost" if IPL were to do so. Petitioner's standing depends upon both facts being true; the record before this Court supports neither.

Also troublesome, insofar as its standing in this Court is concerned, is Petitioner's failure to address the Commonwealth Court's holding that the stranded cost provisions of the Competition Act are not severable from the remainder of the Act. The notion that IPL is a potential competitor of PECO for the patronage of Pennsylvania retail electric customers is grounded entirely on the supposition that the Competition Act validly confers upon out-of-state generators the opportunity to sell electric power at retail in Pennsylvania. Indeed, the Petition does not claim that any such right would exist if the Competition Act were repealed or invalidated. At the same time, the Commonwealth Court's analysis compels the conclusion that the injury IPL complains of cannot be redressed without invalidating the Competition Act. Stated simply, if stranded cost recovery under the Competition Act were declared unconstitutional, IPL would be entirely precluded from competing for retail customers in Pennsylvania. Rather than redressing Petitioner's alleged grievance, this result would put IPL in a far worse position.

CONCLUSION

The Commonwealth Court thoroughly analyzed Pennsylvania's Competition Act, applying this Court's precedents to the record in this matter, and sustained that Act on a variety of grounds. The Petition offers no sound reason why this Court should review that clearly correct result, and the Petition For Writ of Certiorari should be denied.

Respectfully submitted,

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APPENDIX

APPENDIX A — EXCERPTS OF REPORT AND RECOMMENDATION ON THE INVESTIGATION INTO RETAIL ELECTRIC COMPETITION

Docket No. I-940032

PENNSYLVANIA PUBLIC UTILITY COMMISSION
July 3, 1996

* * *

II. BACKGROUND

At a Public Meeting held April 14, 1994, the Commission instituted an Investigation to examine the structure, performance and role of competition in Pennsylvania's electric utility industry. The Commission took this action to gather and analyze data on the electric competition issue and to present our recommendations to the Governor, General Assembly and the public. The fundamental issue is whether the electric industry can be restructured to a more competitive regime and regulation diminished in order to promote the public interest. The Commission appreciates those who participated in this Investigation and provided comments for consideration.[1]

One factor driving a move to restructuring is the disparity in electric rates and costs. There is a high disparity in retail

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1. The Commission received comments and testimony from many interested parties including rural electric cooperatives and municipal authorities throughout this Investigation. These parties made a valuable contribution to the development of this Report. They also convincingly conveyed the many differences which distinguish them from the regulated utility companies. In this light, we recognize that the recommendations of this Report are not meant to address either the cooperatives or the municipal electric systems.

electric rates across Pennsylvania and between Pennsylvania and many other states. As of January 1996, Pennsylvania residential electricity prices ranged from 6.69 to 11.58 cents per kwh. Industrial rates ranged from 4.53 to 7.13 cents per kwh. Nationwide, Pennsylvania rates are in the highest 25% of electricity rates when compared with all other states.[2]

Additionally, there is a significant difference between the marginal cost of electric power production and existing retail rates. Existing rates include the recovery of the cost of capital investments that were incurred in the past. These costs were associated with available technologies and efficiencies. Current marginal costs are significantly lower than electric energy rates primarily because of reduced capital cost, improved production efficiencies, and favorable oil and gas prices. These factors combined with federal energy policy changes, such as the 1992 Energy Policy Act, have created an environment in which more low cost generation is available.

The Commission's Investigation Order directed all jurisdictional electric utilities to file comments and requested the same of any interested party. A Commission Staff Report was issued on August 4, 1995. The completion and release of the Staff Report was an interim step in this Investigation. The Commission issued another Order on September 27, 1995, requesting parties to file testimony addressing the Staff Report and a series of questions dealing with electric competition and restructuring.

There was broad-based public participation in response to our request. Parties submitted both pre-filed, written testimony

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2. *Electric Power Monthly*, Energy Information Administration, March 1996, p. 76.

and oral testimony. Commissioners were given an opportunity to ask questions of each presenter. Following these hearings, three public input hearings were held to solicit comments from the general public. This Report is the culmination of the Investigation.

* * *

3. *Stranded Costs*

Dealing with stranded costs is one of the most difficult issues to be resolved in our efforts to move to a competitive electric utility industry. If consumer prices are to be based on market prices instead of regulated rates, market prices may not be sufficient to recover all existing utility investments and expenses. In general terms, costs currently included in rates which exceed the market value of the related asset are uneconomic. Upon the transition from regulated rates to market-based prices, uneconomic costs may become stranded to the extent that they are not recovered by market prices. These costs are in the regulated rates that consumers pay today, although they are not explicitly identified as stranded costs. If no changes in industry structure or the regulatory regime are made, consumers will continue to pay these costs over the life of the investment. Stranded costs also include expenses which were incurred during price regulation but have not yet been recovered from customers and may not be recovered under competitive market pricing.

Specifically, the Commission finds that the elements of the current utility cost structure that may be stranded fall into four categories: (1) Regulatory Assets (deferred taxes, post-retirement employee benefits, etc.), (2) Non-utility Generator

Contracts, (3) Utility Generation Assets (primarily nuclear power plants), and (4) Nuclear Decommissioning Expenses. These costs must either be mitigated by a utility as part of a transition to retail competition or recovered during a phase-in to full retail competition.

a. Mitigation of Stranded Costs. The Commission expects that the utilities will continue to identify and to take vigorous steps during the transition period to mitigate stranded costs as much as possible. "Mitigation" is a broad term which includes any action that a utility might take to reduce stranded costs. Utilities should take notice that, as of the date of this Report, companies should take actions to improve their competitive position and to reduce their risks. The Commission supports transition policies that address and mitigate stranded costs as an important step in promoting competition in the electricity market. But mitigation strategies must not result in an increase in either (1) base rate charges by customer class during the transition period, or (2) Energy Cost Rate (ECR) charges, with the exception of the impact of PURPA-related projects. As the Commission reviews actual mitigation efforts of each utility in determining a reasonable stranded cost recovery amount, we will consider the burden of mitigation efforts on consumers and shareholders alike.

The Commission will provide accounting flexibility in support of mitigation measures such as accelerated depreciation, debt level buy downs, and regulatory asset retirement. During the transition period, electric utilities will be required to submit plans to the Commission for mitigation. At the milestone reviews, each utility's mitigation strategies and results will be evaluated.

Appendix A

Several of our electric utilities are already attempting to mitigate stranded costs through a number of proposals before the Commission. The mitigation strategies filed with the Commission to date include: accelerated depreciation of utility generating facilities, renegotiation and buy-out of non-utility generator contracts, accelerated amortization of regulatory assets, and accelerated decommissioning plans. PECO Energy (PECO) and Pennsylvania Power Company (Penn Power)[9] have filed accelerated depreciation plans for their nuclear power plants. Metropolitan Edison Company (Met-Ed), Pennsylvania Power & Light Company (PP&L), and West Penn Power Company (West Penn) have petitioned the Commission for approval of buy-out proposals on a number of their non-utility generation contracts. Duquesne Light Company (Duquesne) and Penn Power have filed accelerated nuclear decommissioning plans.

A utility also can mitigate stranded costs by selling assets and using the proceeds to fund other mitigation efforts. Duquesne Light has used this strategy in the sale of its interest in the Fort Martin generating facility. Duquesne is using the profits from this sale to mitigate stranded costs by writing-off a portion of its investment in nuclear facilities, accelerating depreciation of nuclear facilities, and accelerating amortization of nuclear decommissioning expenses.

In addition, there are several other potential mitigation strategies that should be vigorously employed. Utilities can operate more efficiently and reduce operating expenses. When utilities operate generation facilities more efficiently, the

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9. Penn Power's Petition was approved by the Commission at its June 20, 1996 Public Meeting. Docket No. P-00961028.

generation from those plants is more competitive, thereby reducing potentially stranded costs. Most Pennsylvania utilities also have reduced the cost of operating local distribution and customer services. When a utility reduces operating costs for such services, it is able to continue to collect the higher cost of service in existing rates to support other expenses or dividends until such time as new rates are determined. Lastly, utilities which forego increased earning growth or reduce dividends are making a shareholder contribution to stranded cost mitigation if such resources are used to fund mitigation efforts. The Commission is particularly interested in mitigation strategies employed and will closely scrutinize these efforts in individual proceedings. In this regard, it should not be assumed that foregone earnings below authorized return on equity constitute mitigation funding absent further explanation of how earnings were applied against uneconomic costs.

Mitigation also can be accomplished if a utility chooses to write-off a portion of the book value of an asset which is above market value. The utility and its shareholders only bear the burden of such a write-off once the return of or return on that investment is no longer included in regulated rates.

Thus, "mitigation" is a broad term which includes both cost savings which benefit consumers and shareholders, and strategies which utilize existing ratepayer and/or shareholder funds for different purposes. In evaluating any mitigation strategy, it is important to assess the degree to which ratepayers, shareholders or both are bearing the burden or receiving the benefits of the mitigation activity.

As the Commission requires utilities to mitigate stranded investments vigorously and prudently and to the maximum

extent possible, the Commission will pay close attention to the benefits and to the burdens that result from each mitigation effort. Utilities which: (1) from the beginning, act more effectively to avoid uneconomic costs; (2) make greater efforts to mitigate stranded investments; and (3) bear a burden of stranded investment mitigation should be recognized for their performance through increased opportunity for recovery of non-mitigated investments.

b. Principles for Recovery of Stranded Costs. By the conclusion of the transition period, the Commission will complete its review of stranded costs that have not been successfully mitigated and will determine the level of stranded costs that will be eligible for cost recovery through a mechanism called a Competitive Transition Charge (CTC).

The CTC will not likely be the primary source of stranded costs recovery. Even if a CTC permitted utilities to recover every conceivable stranded cost, most utilities still would recover a substantial portion of uneconomic costs through regulated rates from customers who have not chosen alternative sources of generation. All consumers will continue to pay regulated rates which include uneconomic costs during the transition period before consumers are allowed to choose alternative sources of generation. Once consumers are permitted to choose an alternative generation supplier, a large portion of consumers will continue to receive generation services under existing regulated rates for some time to come. Thus, during both the transition and phase-in periods, a large portion of potentially stranded costs will be recovered directly from consumers who continue to pay regulated rates.

Utilities will be required to identify, as stranded costs recovery, an appropriate portion of the revenue stream which

it collects from customers and apply it to write-down the value of uneconomic assets. This transition will substantially reduce potential stranded costs. For example, if 40% of a utility's customers choose an alternative source of generation during the stranded costs recovery period, and therefore pay a Competitive Transition Charge (CTC), the remaining 60% of its customers will continue to pay for uneconomic investments through regulated rates.

Indeed, each public utility could have a unique financial transition plan because: (1) each has different types and levels of stranded costs, (2) each has undertaken varying efforts to avoid or reduce stranded costs, and (3) each has undertaken varying efforts to bear the burden of uneconomic costs. Further, it is important to emphasize that each electric utility will have a different level of uneconomic cost recovery from customers continuing to pay regulated rates. Different financial transition plans will directly affect the level and timing of price reduction opportunities for consumers.

While the financial transition plan may be unique for each utility, guiding principles which apply to all utilities can establish a transition which balances competing concerns of different utilities and consumers. In addition to the principles in the foregoing discussion, the Commission will consider the following principles in authorizing stranded cost recovery for each utility:

i. The financial transition principles should provide an incentive for utilities to remove stranded costs from prices as quickly as possible in order to gain the benefits of restructuring in a timely manner. In addition, utilities will experience the impact of

stranded costs on their financial condition immediately upon making the transition to competitive pricing. Thus, it is in their interest to eliminate or reduce any uneconomic costs as quickly as possible.

ii. Recovery of stranded costs must not increase prices above current rates by customer class. The transition period must permit recovery in a way which does not have a negative impact on consumers. The transition to market pricing means that some uneconomic investments which presently are being recovered over an extended period of time (perhaps 20 or 30 years) instead will be recovered in a much shorter period. A financial transition that accelerates such recovery exerts upward pressure on rates during the recovery period. The transition must be designed such that existing rates are the absolute cap for each class of consumers. As a general rule, stranded cost recovery must not result in an increase in either base rate or ECR charges during the transition period. In addition, the Commission will closely scrutinize and avoid mitigation efforts and cost recovery which shifts the burden of uneconomic costs among classes of ratepayers.

An important exception to the accelerated recovery of stranded costs is that stranded costs should not be recoverable from consumers until they are actually accrued by the utility. For example, utilities have already invested in generating facilities which are potentially stranded costs. However,

utilities have not yet actually made future non-utility generator contract payments nor nuclear decommissioning trust fund contributions. Such expenses should be collected from ratepayers as they are incurred. This principle retains payment of these expenses by consumers, just as exists now, without acceleration. A possible alternative would be for utilities to collect some future expenses at their present value.

iii. Utility recovery and consumer burdens must be shared and balanced. Fairness among utilities and between utilities and consumers requires a balanced sharing of stranded costs. Utilities should receive a reasonable opportunity for, but no guarantee of, recovery of up to 100% of net, unmitigated stranded costs.

iv. Only net stranded costs should be recoverable. Restructuring will not only reduce the value of certain utility assets, it will increase the value of other assets as well. For example, some utility assets have been fully or substantially depreciated, and therefore fully paid for, and may have significant residual value which will remain a utility asset. This residual value of generating assets must be subtracted from the stranded costs to calculate the total amount of recovery.

v. Different recovery levels should be permitted for different categories of stranded costs. Each of these categories reflect differing degrees of management responsibility for the stranded costs that may exist

and different utility benefits from costs which may now become stranded. In addition, as usually calculated, stranded costs include not only return *of* the investment (principal), but also return *on* the investment (earnings). The Commission believes this is a fundamental distinction.

vi. Stranded costs recovery must be conditioned on the reasonable availability of the asset. Any generating asset for which stranded costs are obtained must be dedicated to serving the consumers who are being required to pay for it. As such, plants must be held to an acceptable performance standard as well.

vii. Stranded costs recovery plans must contain assurances of operating safety. Utilities must not have any incentive to compromise operating safety on uneconomic assets.

viii. Stranded costs recovery plans must guard against deterioration of customer services and propose verifiable measures to remediate customer service problems.

c. Recovery of Specific Stranded Costs. In addition to uneconomic costs which will continue to be recovered by utilities from customers remaining on regulated rates, the CTC should include recovery for different types of stranded costs from customers choosing alternative generators as follows:

i. *Regulatory Assets.* As a result of this Investigation, the Commission recommends that thorough consideration be given to the level of

recovery for the generation portion of unmitigated regulatory assets on the books of the utility. Since regulatory assets represent existing deferrals of recovery for approved expenses, they should receive priority recovery under the cost recovery mechanism.

ii. *Non-utility generator (NUG) Contracts*. This category of stranded costs are agreements that utilities have with independent power producers for the purchase of energy or capacity. Some of these agreements pose a potential stranded costs problem for electric utilities because the price they pay for the power produced by these facilities may be higher than the expected market price of electricity.

These contracts became an obligation of the utilities because of a requirement by the federal government that utilities purchase power made available by qualifying facilities (QF). In 1978, Congress passed the National Energy Act (NEA) to reduce the country's dependence on foreign oil. PURPA also implements the policies of the NEA and requires electric utilities to purchase electricity from a QF based upon the utilities' avoided cost. Avoided cost is defined as the price the utility would otherwise have incurred for its power rather than purchasing it from the QF. The problem of NUG stranded costs exists because the utilities' avoided cost at the time the contracts were negotiated was based on projected substantial increases in fuel prices. However, energy prices decreased during the 1980s. The average price paid for NUG contracts is 6.10 cents per kwh. Consequently, electric utilities

must purchase power at a higher price than is currently available in the market or at prices higher than the current cost of a newly-constructed generator plant.[10]

As a result of this Investigation, the Commission recommends that utilities be authorized to collect the costs of currently effective and approved NUG contracts as they are incurred. Utilities should vigorously seek to renegotiate or to voluntarily buy-out uneconomic NUG contracts, especially contracts for facilities which have not yet been built. Since NUG contracts were required by law, utilities will have the opportunity to request recovery of the unmitigated prudent costs of such contracts within the cost recovery mechanism.

iii. *Electric Utility Generation.* The third element of identified stranded costs for electric utilities is uneconomic generation assets, primarily nuclear power plants. The seven major investor-owned electric utilities in Pennsylvania had an original cost in nuclear generation power plants of $15.6 billion. Pennsylvania's current net plant investment in nuclear power plants is $12.3 billion.[11]

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10. From 1985 through 1994, Pennsylvania's electric utilities purchased 41,331 gigawatt hours of electricity from NUGS at a cost of about $2.5 billion. The federal government and the Commission historically played a significant role in requiring jurisdictional electric utilities to purchase capacity and associated energy from NUGS.

11. *Restructuring of the Electric Power Industry in Pennsylvania*, Z. Ahmed Kaloko, Ph.D. (1995).

Appendix A

Electric utilities have invested heavily in their generation assets based on the existing system of rate base/rate of return regulation. That is to say, a utility receives a certificated service territory in which it is the supplier of power. In return it commits to build its system as necessary to serve the current and future needs of all customers in the service area. The utility is then allowed to recover the cost of prudent investment it makes to provide such service, plus the opportunity to earn a regulated return on investment.

There can be no doubt that the existing ratemaking system itself has significantly contributed to stranded utility investments. Current regulated rates are the result of the existing ratemaking rules and procedures under the Code. The wide disparity in existing rates also demonstrates that utilities made substantially different decisions and responses to the same ratemaking rules. For example, decisions to invest in nuclear power in the 1960s and 1970s have produced higher cost power than decisions to build generation which utilizes other fuels.

As a result of this Investigation, the Commission recommends that utility generation assets not mitigated during the transition period, which have book values above market, should be netted against utility generation assets that have book values below market. Any excess would then be reviewed by the Commission according to the principles contained in this Report. The Commission

will then determine a reasonable recovery amount not to exceed the net, unmitigated depreciated costs; up to 100% recovery. In addition, the allowance of a return on equity element of net stranded generation costs based upon the principles contained in this Report is one component that utilities might seek to include in their computation of stranded costs. In particular, the Commission will scrutinize a utility's efforts to mitigate stranded costs during the transition period. The Commission will also evaluate the actions taken by the utility to foster a more competitive electrical energy marketplace. It should be noted that under the current ratemaking system, the authorized return on equity established by Commission decisions may have already compensated shareholders for the business and for competitive risks inherent in their investments.

iv. *Nuclear Decommissioning Expenses.* Federal law provides that utilities which constructed nuclear generating stations must annually contribute monies to a trust fund to be applied to the decommissioning expenses associated with the plant's retirement. Consumers have been paying an amount designated to achieve this goal, although estimates of the cost of future nuclear decommissioning are accelerating rapidly. Similarly, the anticipated retirement dates for some plants have been moved up for both economic and operational reasons. Thus, decommissioning may not be fully funded absent the ability to continue to collect funds for this purpose. While utilities could be required to bear some portion of nuclear decommissioning expenses,

the need to assure safe nuclear decommissioning in the future requires that consumers continue to fund a reasonable share of prudent nuclear decommissioning expenses over the remaining life of the facility.

v. *Exclusions from Recovery*. As previously indicated, utilities should not recover any transition costs which could have been mitigated by the utility and are already recovered through a net increase in the value of other assets. Additionally, Commission-authorized recoverable stranded costs must be limited to costs which have decreased in value as a result of the change to a competitive retail generation market. Similarly, assets which have a market value that is less than book value for any reason other than the transition to retail competition should not be recoverable in the CTC. Lastly, recoverable stranded costs must not include any assets which were previously determined by the Commission not to be used and useful.

d. Recovery of Stranded Costs. It is the recommendation of this Commission that recoverable stranded costs, as determined by the Commission pursuant to the considerations outlined, should be recovered by a non-bypassable surcharge, the CTC. Use of a CTC is the most effective and fair way to recover these costs. All retail customers located in the utility's distribution service territory are expected to contribute to stranded costs recovery. By including these costs, which would be paid by all retail distribution customers for whom the costs were incurred, stranded costs would be removed from generation rates so that some presently uneconomic generation

facilities could be competitive. Additionally, since the cost of recovering the stranded costs would not be reflected in generation prices, the recovery charge would not be a barrier to choosing alternative generation suppliers.

Thus, there will be no core customers who must bear the entire ratepayer burden of stranded costs since departing ratepayers will not be able avoid such costs. Consumers who choose alternative generation suppliers will pay a CTC. Consequently, consumers remaining under regulated rates will not pay a CTC, although they will continue to pay for uneconomic costs as part of existing base rates.

e. Proceedings. The Commission will conduct hearings to examine each company's specific estimates of stranded costs and any proposed recovery mechanism for use during the phase-in period. These proceedings are designed to apply, on a case-by-case basis, the standards and guidelines expressed above.

In order to receive recovery of stranded costs or other transition costs, a utility is expected to file a Recovery Plan which: (1) establishes that the utility will cooperate with the Commission to facilitate the transition by providing necessary information, and (2) documents anticipated items and levels of stranded costs, other transition costs, offsetting increases of the value of identified assets, uneconomic costs which are recovered through base rates, mitigation strategies and anticipated recovery amounts. The Commission will review the Recovery Plan with the participation of interested parties, consistent with due process requirements, and establish a CTC. In addition to establishing anticipated stranded costs recovery through the CTC, the Commission will establish anticipated revenues in regulated rates which will be available to mitigate

stranded costs. Since actual recovery requirements will depend on market values, actual mitigation efforts and other variables, the CTC may be adjusted annually based upon updated documentation. Any transition costs not recovered within the phase-in period should not be recoverable unless otherwise authorized by the Commission.

Calculating the amount of stranded costs is a function of the market price for electricity in a competitive market. Since we do not know what the market price will be in a fully competitive market, we can only estimate the magnitude of this cost at any point in time. However, our consideration of stranded costs will be most efficient if the estimates for each utility are based on consistent definitions and methodologies.

f. Legal and Policy Issues Related to Stranded Costs. There are two primary legal issues related to stranded cost recovery. First, the Commission must have legal authority to authorize utilities to recover stranded costs. The Commission concludes that it may not have sufficiently clear legal authority to provide for the recovery of stranded costs.[12]

The second primary legal issue related to stranded cost recovery is whether the law requires any aspect of stranded cost recovery. Some utilities have argued that they are constitutionally entitled to full recovery of all stranded investment. They argue that anything less than full recovery is an unconstitutional taking of property without just compensation in violation of the Fifth Amendment. We cannot agree.

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12. *See Barasch v. Pa. Public Utility Commission*, 516 Pa. 142, 532 A.2d 325 (1987); *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

Appendix A

The Commission concludes that the United States Constitution does not *require* the Commission to permit full recovery of stranded costs. The due process clause of the Constitution has been applied to prevent governmental destruction of existing economic values, but it has not been and cannot be applied to ensure values or to restore values that have been lost by operation of economic forces; thus, there is no constitutional right to recover uneconomic investments.[13]

Yet, this conclusion does not end the debate. Some utilities also argue that changing the ratemaking system raises a constitutional and basic question of fairness. This argument does have some merit. Although a utility has no constitutional right to the continued use of a particular ratemaking system, such a change does raise questions of fairness. Fairness to utilities must be balanced with fairness to consumers and the public interest requirements of lower electric prices. We must accept the fact that the restructuring we recommend does change the rules of the game after utilities made decisions and investments based on the then-existing rules.

Hence, we conclude that the law does not require any particular recovery of stranded costs.[14] Nor is stranded cost recovery, as a threshold matter or at any particular level, constitutionally mandated.

This Commission does not intend to convert the opportunity to recover stranded costs into a guarantee of recovery. Utilities

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13. *Market Street Railway Co. v. California Railroad Commission*, 324 U.S. 548 (1945).

14. *See Federal Power Commission v. Hope Natural Gas*, 380 U.S. 591 (1944) and *Bluefield Water Works and Improvement Co. v. Public Service Commission*, 262 U.S. 679 (1923).

should have a reasonable opportunity to recover stranded costs based on the principles outlined in this Report. We believe that this outcome is constitutionally permitted, although it is not constitutionally required.

The Commission will determine that just and reasonable rates are to be determined primarily through market pricing. The Commission will balance the interests of consumers and shareholders on a case-by-case basis. Moreover, under an acceptable stranded costs recovery plan, the incumbent utility will have the burden to demonstrate that the stranded costs are verifiable, prudently incurred and that mitigation efforts will be as vigorous as possible.

We recognize that to move the full competition without making a provision for stranded costs recovery could provoke costly, reform-delaying litigation. These factors may invariably reduce the quality of electric service and delay the arrival of the benefits of competition. Delay and litigation are certainly not in the public interest.

Acceptance of all of the foregoing concerns warrants that we balance fairness to the utilities and to ratepayers so that the burden of stranded costs is appropriately shared. However, the Commission concludes that utilities should have an opportunity to seek recovery of up to 100% of net, unmitigated stranded costs during the phase-in period from regulation to competition in the electric generation sector. We encourage the General Assembly to provide explicit authority for the Commission to permit recovery of a reasonable portion of stranded costs based upon the principles outlined in this Report. In particular, the "used and useful" standard, enunciated in Section 1315 of the Code can be amended to permit reasonable recovery of stranded costs.

* * *

APPENDIX B — BRIEF OVERVIEW OF SECURITIZATION BY KENNETH ROSE

The National Regulatory Research Institute
The Ohio State University

The Process

An often discussed means of dealing with potential electric utility "stranded costs" is securitization. Securitization refers to the creation of a financial security or bond that is backed by a revenue stream pledged to pay the principal and interest of that security. This device provides utilities an up-front, lump-sum payment from the sale of the security. Securitization requires the creation of a transferrable property right (thus far, through legislation) to collect from the utility's ratepayers a "customer transition charge" or through some other "non-bypassable" obligation placed on ratepayers. The charge is usually, but not always, based on some portion of the utility's "stranded" or uneconomic costs. If this option is exercised by the utility, the property right can be transferred by the utility to a designated trustee, a "bankruptcy remote special purpose entity." The trustee then issues a bond and pays the utility the cash proceeds from the sale of the security in the financial market less transaction costs. The securitized bondholders then have the right to collect the charge from the utility's customers that are obligated to pay it. The utility or distribution company collects the customer charge from the customers and transfers the funds to the trustee that then transfers it to the securitized bondholders. The cash proceeds the utility receives should equal the discounted present value of the customer charge revenue stream.

Appendix B

Current State Action

Currently, California, Pennsylvania, Montana, Illinois, Massachusetts, Rhode Island, and Connecticut have adopted legislation that allows utilities to use this option and other states are considering it. In December 1997, three investor-owned utilities in California issued a total of $6.1 billion in securitized bonds (these companies have been authorized by the California Public Utilities Commission to issue up to $7.3 billion).

Advantages

The securities are essentially backed by a pledge that the securities will be paid in full, including principal, interest, and financing costs. These securities have a value because of the promise to create and sustain the revenue stream from the customer charge until the debt is paid. The bonds are evaluated for investment purposes based on the strength of this pledge and the likelihood that the revenue stream to the bondholders will be sustained throughout the term of the bonds. The benefits of securitization come primarily from the replacement or refinancing of the utility's existing capital structure of debt and equity with lower-cost debt. Any savings realized from securitization are often required to be given back to retail customers in the form of either a rate reduction or a reduction in the amount of recoverable "stranded cost."

Limitations

While securitization can potentially lower the capital carrying cost, there are at least three significant drawbacks for customers. First, to obtain a higher bond rating than current utility debt and realize the lower debt cost, any securities issued

would have to be irrevocable and assurances given that recovery is guaranteed for the life of the bond. Securitization provisions usually contain a true-up mechanism that raises or lowers the customer charge to adjust for changes in the number of customers or demand level. However, the amount initially set as the principal of the bond cannot be changed. This may be a problem if the actual amount of competitive loss is less than the amount forecasted when the principal was authorized. Estimates of a utility's competitive loss are based on dozens of explicit and implicit assumptions used in the analysis, any number of which may turn out to be incorrect. In addition, the estimated results are highly sensitive and change substantially when there are only slight changes in the assumptions. This represents a significant risk for customers who would have no recourse if the loss does not materialize as expected. In some cases, no loss may appear at all and the company may actually realize a financial gain.

A second limitation is that securitization results in a large infusion of cash into the utility. A state may be able to require that the cash will be used to buy back equity and reduce debt; however, in a holding company structure the utility can simply transfer the cash to the holding company. This money can be used in any manner the holding company desires, including using it to restrict competition. This would be a special advantage granted to the incumbent utility and could be used for anticompetitive purposes.

A third limitation is also related to the irrevocableness of the bond. Generally, in either a competitive market or in regulated industries, the appropriateness of a firm's costs is disciplined and monitored by the market or, however imperfectly, a regulator. Under regulation, utility costs are

subject to possible review (through prudence or used and useful tests) by the regulator. Of course, in a competitive market risks are usually placed on the company and its investors and provide a strong incentive to control costs to remain competitive. Securitization limits the ability of both the market and the regulator to discipline or revisit securitized costs and determine the appropriateness of recovery when future market conditions change. This transfers significant risk to utility customers that were once borne by the utility under regulation or that would occur in a competitive generation market. This is the primary reason for the perceived lower risk to the utility (and the resulting lower cost of capital) associated with securitization when compared to ordinary utility debt refinancing.

APPENDIX C — EXCERPT OF TESTIMONY OF DR. WILLIAM HIERONYMUS REGARDING MARKET PRICES FOR PECO ENERGY GENERATION BEFORE THE PENNSYLVANIA PUBLIC UTILITY COMMISSION

APPLICATION OF PECO ENERGY COMPANY FOR ISSUANCE OF A QUALIFIED RATE ORDER UNDER SECTIONS 2808 AND 2812 OF THE PUBLIC UTILITY CODE

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The Effect Of Stranded Cost Recovery on Competition

Q. **Mr. Brehm asserts that if PECO and other Pennsylvania utilities are allowed to recover their stranded costs, and particularly if stranded cost recovery is based on projected market prices that are below long run marginal costs, then out-of-state competitors and competition will be harmed. Do you agree?**

A. No. It is important, first, to be aware that competitive prices are based on short run marginal costs. They also may equal, and indeed will tend over the long term toward, long run marginal costs. However, at any point in time, the price in the market will be set by the short run marginal cost of the most expensive (in terms of marginal cost) generation required to meet load. This is basic economics. The reasoning, quite simply, is that all producers will wish to sell all output for which they can make a contribution to fixed cost and profit. Stated otherwise, the refusal to sell output when the market price is above marginal cost will reduce profits by the amount of such contribution that would have been earned on the output. Competition among sellers, all of whom face these same incentives, will drive

the price down to the highest marginal cost of output demanded by consumers at that point in time.

Short run marginal cost is the variable operation and maintenance expense of producing an additional increment of output, including the variable fuel cost of production. It expressly does not include sunk capital costs that exist independently from the level of output. Nor does it include future costs that cannot be avoided by curtailing output. It also does not include other balance sheet costs such as regulatory assets.

Setting aside the extreme case of bankruptcy (which may increase short run marginal costs), the short run marginal costs of Pennsylvania utilities will not be affected by the level of stranded cost recovery (provided only that stranded cost recovery is not conditioned on continuing to operate all facilities irrespective of whether it is economic to do so). It follows that market prices for delivered bulk power in Pennsylvania will not be affected by stranded cost recovery. Neither competition, nor competitors will be injured.

Curiously, Mr. Brehm in a different context acknowledges that sunk costs have nothing to do with market prices. He uses the example of three firms with equal capability to produce output, one of which has a book cost of $2 billion, one a cost of $1 billion and one a cost of $0.5 billion. Each has the same market value because all would face the same prices for their output. Clearly, if the level of sunk cost does not affect prices, it follows also that the recovery of some portion of it outside of the generation market also will not affect prices.

Appendix C

Q. Mr. Brehm argues that in the past utilities may have kept open plant that should have been closed and asserts that PECO may be planning to keep open generating facilities that should be closed or at least not life extended. Isn't it the case that keeping open uneconomic facilities can depress prices, injuring competitors?

A. In principle, yes. However, this also has nothing to do with stranded cost recovery. If in the past it was necessary to continue to operate uneconomic facilities in order to keep them in rate base, there would have been an incentive to operate them when the value to shareholders of keeping them in rate base exceeded any costs they bore from uneconomic operation. However, my understanding of the situation in Pennsylvania is that stranded cost recovery is not contingent on the continued operation of the facilities with which it is associated if those facilities are rendered uneconomic by virtue of the transition to competition. A Pennsylvania utility will have no incentive to keep open those facilities that do not earn enough in the marketplace to cover their avoidable costs. In this context, avoidable costs include any fixed O&M and capital expenditures that would be required to keep them open. Hence, stranded cost recovery will not create any incentive to keep open generating stations that economically should be closed.

Q. Mr. Brehm specifically objects also to stranded cost recovery that reduces PECO's remaining costs of generation to below LRMC. Are there any competitive implications from basing stranded cost quantification and recovery on price levels below LRMC?

Appendix C

A. No. At a latter point in my testimony I will discuss Mr. Brehm and Mr. Falkenberg's assumption that market prices should equal LRMC. However, I will deal here with the narrower question of whether basing stranded cost recovery on forecasts of market prices below LRMC does harm to competitors.

Mr. Mendl makes a related point, asserting that if PECO is allowed excessive stranded cost recovery it either will earn excess profits (in effect, recover the same costs from the market and from stranded cost recovery provisions) or will injure competitors by selling at below market prices. Both Mr. Brehm's and Mr. Mendl's competitive concerns are mis-placed. If, hypothetically, PECO is granted a too high stranded cost recovery (and it is able to recoup the allowed stranded cost under its price cap), shareholders will have benefited. However, this will not harm competitors. It will not be in PECO's interest to sell at below market prices irrespective of whether it recovers all, more than, or less than its stranded costs. PECO's interest will be in maximizing returns to shareholders and, as is the case with competitive firms generally, this is not accomplished by giving away its output at below market prices. This is true whether the market price turns out to be above or below LRMC.

This actually is simply common sense. Suppose that the City of Boston decides that it is in its interest to build a football stadium in order to retain its NFL team. Does this mean that ticket prices will be less than they would be if the team had paid for the stadium itself? Presumably not, since it will set ticket prices at the profit maximizing price. An even better analogy would be if a steel company

acquired a facility at what turned out to be a below market price. Would it sell steel any cheaper as a result? No, it would sell steel at the market price and simply be more profitable because its book costs were lower.

The sole exception to this common sense rule has to do with predation. If PECO is "enriched" by stranded cost recovery (or less impoverished by some amount of stranded cost recovery), it arguably will be better able to bear the profit loss caused by its predatory pricing than if it had less deep pockets. However, the economic case for predation is very limited. In order to profitably engage in predatory pricing it is necessary to be able to drive competitors out of the market and keep them from returning. Assume, hypothetically, that PECO chose to drive down the price of power in Pennsylvania below the competitive level. PECO itself would lose money that it could have made at the competitive price. IPL (and other out-of-state utilities) might indeed choose to sell their output elsewhere. New generators might decide not to build plants for the Pennsylvania market. However, as soon as PECO began trying to sell power at above the competitive price (as it would have to be able to do if it was to recover the profits lost by starting the price war), IPL would turn around and sell into Pennsylvania, entrants would seek to build to serve this high priced market, and the forces of supply and demand quickly would drive prices back down to the competitive level. In my opinion, it is highly unlikely that predatory pricing will be profitable in US electricity markets for any firm.

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APPENDIX D — EXCERPT OF TESTIMONY OF JOHN R. BREHM, SENIOR VICE PRESIDENT — FINANCE AND INFORMATION SERVICES, INDIANAPOLIS POWER & LIGHT COMPANY, BEFORE THE PENNSYLVANIA PUBLIC UTILITY COMMISSION

APPLICATION OF PECO ENERGY COMPANY FOR ISSUANCE OF A QUALIFIED RATE ORDER UNDER SECTIONS 2808 AND 2812 OF THE PUBLIC UTILITY CODE

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Q26. Doesn't IPL oppose all stranded cost recovery?

(a) IPL does not oppose stranded cost recovery per se; however, we believe stranded cost recovery should not be based on the departure of a utility's outstanding securities' value from its book accounting cost but rather from the departure from the actual true current value of its assets which is best represented by replacement costs.

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